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SUBJECT: Ecuador Lowers Interest Rate Ceilings

Reftel: 07 Quito 1655

¶1. (SBU) Summary. Empowered by a slightly modified year-old banking law, the Central Bank has steadily lowered maximum allowable interest rates for the banking sector since January 2008. Ironically, the Constitutional Court struck down a provision of the 2007 banking law that provided transparent guidelines for establishing interest rate ceilings. Without that provision, the Central Bank has continued to set interest rate ceilings, but is not using any publicly understood criteria and appears to be guided by a political desire to lower interest rates. Despite the pressure on interest rates, large banks remain profitable. However, micro-lending is taking a hit, as banks focus on more profitable corporate lending. End summary.

¶2. (U) Ecuador's banking law entered into force in July 2007, establishing new guidelines for maximum lending rates (reftel). The law stipulated that the Central Bank would establish maximum interest rates by market segment, based on the average of prevailing loan rates in the previous month for the segment plus a margin of two standard deviations. The law also banned loan commissions, which had been an important source of income for many banks. However, by dividing the industry into market segments, and providing a reasonably large margin over the average prevailing interest rates, the new law allowed for banks to continue offering a wide range of products within each segment.

¶3. (SBU) In December, the Constitutional Court declared the methodology for setting maximum interest rates unconstitutional, but otherwise left the July banking law intact. With that change, the Central Bank maintained its authority to set maximum interest rates, but was not bound by an established methodology. Starting in January, the Central Bank has begun to steadily lower the maximum interest rates across all market segments. Bankers complain that they are not aware of any methodology followed by the Central Bank, beyond a political objective of forcing down interest rates.

¶4. (U) Following are the maximum interest rates for different market segments in January and August, showing a steady decline in each segment. (Note: The Central Bank establishes maximum interest rates each month. For convenience we have left out the rates for the intervening months, each of which has been marginally lower than the preceding month.)

Month	January 2008	August 2008
Commercial	11.81	9.66
Personal consumption	21.19	17.26
Housing	13.55	11.66
Microcredit	27.98	25.50
Subsistence microcredit	39.98	35.20

¶5. (SBU) According to Cesar Robalino, President of the Ecuadorian Bankers' Association, the overall banking sector remains strong, even with lower interest rates. However, given overall uncertainty,

coupled with lower interest rates, banks are taking a more defensive position by increasing liquidity and building capital while slowing down lending. As part of that retrenchment, they are beginning to shift business from high cost microcredit lending to low cost corporate lending. Robalino noted that the large banks can more easily make those adjustments, while smaller banks have less flexibility. In addition, smaller banks usually have higher marginal operating costs and are therefore particularly vulnerable to falling income as a result of lower interest rates and eliminating commissions.

¶6. (SBU) Comment: President Correa took office determined to push down interest rates and bank commissions, which had been, on occasion, abusively high. The 2007 banking law was drafted by Congress after it rejected a more draconian version submitted by the Correa Administration. It did impose more limits on the banking sector, but also provided a relatively predictable and flexible interest rate cap system. By overturning one provision of the law, the Constitutional Court effectively gave the Central Bank a free hand to set interest rates as it sees fit, without any constraining methodology. At about the same time, turnover at the Central Bank board allowed Correa to appoint a majority of the board. The board had taken what appears to be a political decision to squeeze down interest rates, although the process has been gradual and thus far has not been a threat to overall banking system.

¶7. (SBU) Comment, continued. Ironically, a second objective of the Correa Administration has been to promote more competition in the banking sector and to encourage microcredit lending. By moving forward with one objective, lowering interest rates, the government is undermining its other objective, since the lower rates favor the large banks and suppress microcredit loans.

HODGES